No. 12664

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER, AND LILLIE S. WEGEFORTH, RESPONDENTS

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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OPINION BELOW

The opinion of the Tax Court (R. 64-98), together with the concurring opinion (R. 98-101), and the dissenting opinion (R. 102-117) are reported at 13 T.C. 984.

JURISDICTION

These consolidated cases involve asserted deficiencies in individual income taxes for the calendar years 1937-1940, inclusive, or for some of those years in the case of some of the taxpayers. Notices of deficiencies were mailed to the taxpayers on April 22, 1944 (R. 197-200), May 13, 1944 (R. 220-228), and on May 26, 1944 (R. 13-

17, 134-141, 169-178). Petitions for redetermination by the Tax Court of the United States were filed by the taxpayers, pursuant to the provisions of Section 272 of the Internal Revenue Code, on June 12, 1944 (R. 6-17, 122-141), July 5, 1944 (R. 155-178), and July 17, 1944 (R. 192-200, 209-228). The decisions of the Tax Court were entered on March 14, 1950. (R. 118, 150-151, 187-188, 205, 236.) The Commissioner filed petitions for review by this Court on June 2, 1950. (R. 119-121, 152-155, 189-192, 206-208, 237-240.) The jurisdiction of this Court rests on Section 1141 (a), Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Section 115 (a)(1), Internal Revenue Code, defines a taxable dividend as a distribution by a corporation out of its earnings or profits accumulated after February 28, 1913. Section 115 (b), among other things, provides that earnings or profits accumulated before March 1, 1913, may be distributed tax-free after the earnings and profits accumulated after that date have been distributed.

The question is whether, in the case of a corporation having a deficit on February 28, 1913, the Tax Court was correct in construing Section 115 (a)(1) in such a way that its earnings after that date must first be devoted to eradicating the deficit before becoming available for distribution as taxable dividends.

STATUTES INVOLVED

The applicable provisions of the statutes involved are set forth in the Appendix, *infra*.

STATEMENT

During the taxable years 1938, 1939, and 1940, the taxpayers, who were stockholders of the J. D. and A. B.

Spreckels Company (referred to as Spreckels Company) received certain distributions from that company. The extent to which those distributions are taxable as dividends constitute the issue for decision. The parties below stipulated how much of the distributions in each year were to be taxed as dividends, depending on how the Tax Court resolved the three issues presented to it for decision, in any combination. (R. 23, 40-55.) Supplemental stipulations were also filed to cover the facts peculiar to each of the taxpayers. (R. 62-64, 147-150, 184-187, 203-204, 233-235.)

The only question on review relates to the Tax Court's decision on issue 2, below, namely, whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company (wholly owned subsidiaries of the Spreckels Company) as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends. (R. 23.) The resolution of this question, the facts of which were also stipulated (R. 31-38), was relevant to determine what taxable dividends the Spreckels Company received from these subsidiaries in prior years and how much were the earnings and profits it inherited on the tax-free liquidation of Oceanic Steamship Company on November 18, 1936. These matters, in turn, affected the amount of the earnings and profits of the Spreckels Company available for the distribution of taxable dividends during the taxable years.

The Tax Court (R. 69-85), with Judges Disney, Arnold and Opper dissenting (R. 102-117), held that the March 1, 1913, deficit of these subsidiaries had to be restored by subsequent earnings before there would be earnings or profits available for the distribution of taxable dividends.

STATEMENT OF POINTS TO BE URGED

The points to be urged by the Commissioner (R. 243-244) are that the Tax Court erred in deciding that the earnings and profits of a corporation accumulated after February 28, 1913, available for the distribution of taxable dividends, must be computed in such a manner that, where a deficit in earnings and profits existed on March 1, 1913, subsequent earnings and profits must first be applied to extinguishing the deficit before there can be a surplus in such accumulated earnings and profits.

SUMMARY OF ARGUMENT

Congress, by Section 115 (a)(1) of the Code, has provided that corporate distributions should be taxed as dividends to the extent made out of the corporation's earnings or profits accumulated after February 28, 1913. The Tax Court, in this case, however, has so construed the statute that, where the corporation possessed a deficit on February 28, 1913, its accumulated earnings and profits in each subsequent year must be calculated from the very beginning of its corporate history, and not only from the viewpoint of what has been accumulated subsequent to February 28, 1913, although the latter is what the statute specifies. The decision below holds that all subsequent earnings must first be devoted to eradicating the February 28, 1913, deficit before they can become available for distribution as dividends.

The Tax Court, just as if Congress had employed meaningless language in the legislation, construes Section 115 (a)(1) as though it contained no reference to earnings or profits accumulated "after February 28, 1913." There is no justification for this alteration in the statutory language. While Congress, in Section 115 (b), a separate subsection, has acted to exempt from tax the distribution of pre-1913 corporate earnings,

that action cannot possibly justify the conclusion that Section 115 (a)(1) does not mean what it says.

The exemption with respect to the distribution of pre-1913 earnings when the corporation possessed a surplus on that date is, on the contrary, specific in its nature and has been narrowly applied so as not to defeat the broader Congressional purpose of taxing the distribution of all post-1913 accumulations of corporate profits. This is the only exemption created by Congress and it has nothing to do with corporations possessing a deficit on the crucial date. The Tax Court, in reading a further exemption into the statute with respect to such corporations, namely, that their post-1913 earnings are first to be devoted to the 1913 deficit, has created an exemption where none was expressly provided by Congress and where there is no other indication that any was intended. Indeed, contrary to the general Congressional purpose, the decision here permits the distribution of post-1913 corporate earnings to escape tax as ordinary income in the hands of the distributees.

The Tax Court was wrong in believing that there must be an equation between the amount of a corporation's surplus, available for dividends as a matter of general corporate law, and the amount of its accumulated earnings and profits, available for the distribution of taxable dividends. In other respects, the courts have held that a divergence between these two, separate concepts is required to effectuate Congressional purposes, particularly the purpose that post-1913 accumulated earnings be taxed to the shareholders when distributed. For the same reason, plus the additional reason that the statute introduces February 28, 1913, as a critical date, which would not be true in corporate accounting, such a divergence is required in this kind of case.

The result reached by the Tax Court gains no stature from its reliance on the word "accumulated." Contrary to the Tax Court, the amount of earnings accumulated after February 28, 1913, is not the same as what has been accumulated from the very start of the corporation's history. Nor do the authorities relied on by the Tax Court support its conclusion in any degree. Indeed, in one case, the Court of Appeals, while it did not analyze the point, actually applied the statute in a contrary manner to that required by the Tax Court.

ARGUMENT

The Earnings or Profits of a Corporation Accumulated After February 28, 1913, Which Are Available for the Distribution of Taxable Dividends, Are Not Affected by a Deficit Existing on February 28, 1913

A. *Preliminary.*

The ultimate legal issue presented by these consolidated cases concerns the proper construction of Section 115 (a)(1) of the Internal Revenue Code (Appendix, *infra*) which, in defining the term "dividend," determines what corporate distributions are taxable as dividends, i.e., as ordinary income, to the recipients. Particularly, that section defines a corporate distribution as a dividend if it is made out of the corporation's "earnings or profits accumulated after February 28, 1913." The question here arises in circumstances where a corporation possessed a deficit in its earnings and profits account on February 28, 1913, but subsequently earned sufficient profits which exceed all subsequent distributions. It is the Commissioner's position that such distributions are to be regarded as dividends, and taxable as such to the shareholders under Code Section 22 (a) (Appendix, *infra*), because they are paid out of "earnings or profits accumulated after February 28, 1913," within the precise language of Section 115

(a)(1). The majority of the Tax Court, however, held that such a corporation must first devote its post-March 1, 1913, earnings to removing the pre-existing deficit before it can possess earnings or profits available for the distribution of dividends. (R. 69-85.) Judge Disney wrote a dissenting opinion which was agreed with by Judges Arnold and Opper. (R. 102-117.)

The Tax Court's construction of Section 115 (a)(1), as will become readily apparent, does violence to the statutory language, for it renders completely superfluous the reference there to earnings or profits accumulated "after February 28, 1913," a reference which, beginning with the Revenue Act of 1916, c. 463, 39 Stat. 756, has appeared in every succeeding Revenue Act and in the Internal Revenue Code. The liberties which the Tax Court took with the legislative language not only go far beyond the only Congressional exception, namely, that corporate earnings accumulated before the time that the Income Tax Act of 1913 became effective [1] should be tax-free when distributed, but also undermines the legislative purpose that all distributions of corporate earnings accumulated after that time should be taxed as dividends to the stockholders. The novel construction of the statute embodied in the opinion below, as will be shown, is unsupported by any persuasive authority.

The taxpayers here are stockholders of the J. D. and A. B. Spreckels Company, which will be referred to as the Spreckels Company, who received distributions from that corporation in 1938, 1939, and 1940; the extent to which those distributions are taxable as dividends to those stockholders forms the nub of the

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[1] That Act, c. 16, 38 Stat. 114, while enacted on October 3, 1913, levied a tax (Section IID) on income accruing after March 1, 1913.

tax controversy.[2] This is dependent on the amount of earnings and profits of the Spreckels Company available for the payment of taxable dividends at the time when the distributions in question were made, and this, in turn, is dependent on the extent to which taxable dividends were received by Spreckels Company in prior years from two wholly owned subsidiaries, Oceanic Steamship Company and Kilauea Sugar Plantation Company, and also on the amount of Oceanic's earnings and profits which passed to the Spreckels Company when the former was liquidated in 1936. (R. 31-38.) Since both subsidiaries possessed deficits in their earnings and profits account on March 1, 1913 (R. 31), and since the proper effect of those deficits on the subsequently accumulated earnings and profits of the subsidiaries (and consequently on those of Spreckels Company) made a difference in the extent to which the taxpayers received taxable dividends, the question for decision concerns the proper treatment of these March 1, 1913, deficits of the subsidiary companies. The parties stipulated in the Tax Court concerning the character of the distributions in question, depending on how the principal issue was resolved, and depending on the resolution of two other issues by the Tax Court which are not in issue on review. (R. 40-56.) As we have seen, the Tax Court ruled that the deficits were required to be absorbed by subsequent earnings before the subsidiaries could possess any earn-

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[2] The consolidated cases of *Commissioner* v. *Adolph B. Spreckels, Dorothy C. Spreckels, Spreckels-Rosekrans Investment Co., John N. Rosekrans*, and *Alma Spreckels Rosekrans* (consolidated in Docket No. 12663), and *Commissioner* v. *Alma de Bretteville Spreckels* (formerly *Alma Spreckels Awl*) (Docket No. 12657), pending in this Court on the Commissioner's petitions for review, involve the same question as it relates to distributions to other stockholders of the Spreckels Company. Those cases, pursuant to stipulation, are being held in abeyance pending final decision in the present cases.

ings or profits accumulated subsequent to March 1, 1913.

The problem presented can best be understood in the light of the history of the statutory definition of the term "dividend," and its constant focus on February 28, 1913, as a point of reference. The Income Tax Act of 1913, *supra,* passed shortly after the adoption of the Sixteenth Amendment to the Constitution and levying a tax on income accruing after March 1, 1913, defined income (Section II B) to include dividends, but did not specify what the word "dividend" meant. In *Lynch* v. *Hornby,* 247 U. S. 339, it was ruled that under the 1913 Act, a corporate distribution made after March 1, 1913, constituted taxable income to the shareholders even though the dividend had been paid out of corporate profits earned prior to the adoption of the constitutional amendment; the Court found no constitutional obstacle to prevent Congress from taxing such distributions as ordinary income to the distributees. However, while *Lynch* v. *Hornby* was still pending in the lower courts, Congress, by Section 2 (a) of the Revenue Act of 1916, *supra,* incorporated a provision which limited dividend income to distributions out of "earnings or profits accrued since" March 1, 1913, and, by Section 1211 of the Revenue Act of 1917, c. 63, 40 Stat. 300, added Section 31 (a) and (b) to the 1916 Act,[3] subsection (a) defining a dividend in terms of distributions from earnings and profits accrued since March 1, 1913, and subsection (b) provid-

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[3] Section 1200 of the 1917 Act amended Section 2 (a) of the 1916 Act (similar to Section 22 (a) of the Internal Revenue Code (Appendix, *infra*), and corresponding provisions of prior Acts) so as to contain a definition of income which included "dividends" and so as to remove the existing provision respecting earnings and profits accrued since March 1, 1913. The statutory pattern has since remained the same, namely, a definition of income to include dividends, and a separate definition of dividends.

ing that "nothing herein shall be construed as taxing any earnings or profits accrued prior to" March 1, 1913, but that such earnings could be distributed exempt from tax "after the distribution of earnings and profits accrued since" March 1, 1913, had been made, and also stating that all corporate distributions "shall be deemed to have been made from the most recently accumulated undivided profits or surplus * * *."

The difference thus drawn in the 1916 Act and the 1917 amendment between corporate accumulations before and after March 1, 1913, while not required by the Sixteenth Amendment, was stated in *Lynch* v. *Hornby, supra,* p. 346, to be a Congressional "concession to the equity of stockholders." From that time on, however, in all succeeding Revenue Acts and in the Internal Revenue Code, despite other changes in the definition relating to dividends, Congress has not only provided that distributions made out of earnings and profits accumulated *prior* to March 1, 1913, *should not* be taxed as dividends, but it has also specifically provided that distributions out of earnings and profits accumulated *after* that date *should be* taxed as dividends to the distributees.

The substance of these provisions of the 1916 Act and of the 1917 amendment appears in Section 115 (a) and (b) of the Code (Appendix, *infra*) in the following language:

> DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *
>
> (b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of

earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

B. *The Tax Court has erroneously construed Section 115 (a) (1) by ignoring the statutory reference to earnings or profits accumulated "after February 28, 1913."*

The Commissioner contends that the definition of a dividend in terms of earnings or profits accumulated "after February 28, 1913" in Section 115 (a)(1) was intended to be meaningful, and that, if the quoted language is not to be ignored completely, it can only signify that earnings and profits accumulated after that critical date are available for distribution as taxable dividends. Contrary to the Tax Court, it cannot mean that, where the corporate existence antedated February 28, 1913, only such earnings and profits as have been accumulated from the very beginning of the corporation's life (rather than those accumulated after February 28, 1913) are distributable as taxable dividends.

The Tax Court, as we have stated, construes Section 115 (a)(1) to mean that, where a corporation possessed a deficit in earnings and profits on February 28, 1913, such deficit must first be eliminated by subsequent earnings before there can be any accumulated earnings and profits available for the distribution of taxable dividends. In other words, according to the Tax Court, in the case of such a corporation, the entire history of its accumulations, and not merely those made since

1913, must be examined to determine whether subsequent distributions are to be considered as taxable dividends.

The answer was well put by the dissenting opinion below which stated (R. 107):

> But this only amounts to the argument that on this tax question, before taxable dividends can be paid, there must be net profits from the inception of the corporation, and that though Congress defined a dividend as from accumulations after February 28, 1913, and used "accumulated" to refer to two distinct periods, before and after that date, yet the word must be held to refer to and encompass the whole corporate life so that, for present tax purposes, there is no accumulation of earnings and profits because of capital impairment in the earlier period. But the statute does not say "profit" or "net profit" or "net profit [or net accumulations] over corporate life," but only "earnings or profits accumulated after February 28, 1913." * * *

If Congress had intended what the Tax Court has here held, the phrase "accumulated after February 28, 1913" in Section 115 (a) (1) would have to be rejected as though it were meaningless legislative verbiage. That is, the construction reached by the Tax Court would have been no different if Section 115 (a) (1), making no reference to February 28, 1913, had simply defined a dividend as a distribution out of the corporation's "accumulated earnings or profits." If the statute had so provided, it would have been sensible to conclude that Congress was referring to the corporation's net accumulations measured over the entire period of its history. But that is not what the statute says. In speaking of what was accumulated *after* a certain date, the statute cannot properly be construed so that the date specified by the legislature loses all significance.

It is no answer to say that Congress was thinking in terms of corporations which possessed a surplus on March 1, 1913, and was seeking to protect the pre-1913 surplus from being taxed as a dividend when distributed. That protection is completely provided by Section 115 (b) which is sufficient, by itself, to insure that the stockholders will not be taxed when pre-March 1, 1913, earnings are distributed, and that such distributions will not be deemed to be made until all post-February 28, 1913, earnings have first been distributed. Congress, as we have seen, has incorporated this protection in a separate subsection ever since the 1917 amendment to the 1916 Act.

The separate language of Section 115 (a) (1), consequently, neither serves the purposes which are in fact accomplished by Section 115 (b), nor may such language be ignored in ascertaining the intent of this separate subsection. If some Congressional meaning is to be given to all of Section 115 (a) (1), including the reference there to February 28, 1913, the construction adopted by the Tax Court must be rejected. Otherwise, it must be concluded that, despite other subsequent revisions, Congress has, ever since 1917, been repeatedly incorporating senseless language in the statutes.

The situation would seem to call for the application of the usual rule of statutory construction to the effect that all the words of a statute are to be given meaning, if possible, and that the legislature is not to be deemed to have inserted surplusage into the statutes. *Market Co.* v. *Hoffman,* 101 U. S. 112, 115-116; *Platt* v. *Union Pacific R. R. Co.,* 99 U. S. 48, 58-59; *Pacific Gas & Elec. Co.* v. *Securities & Exchange Com'n,* 127 F. 2d 378, 382, on review by the Court *en banc,* 139 F. 2d 298 (C.A. 9th), affirmed *per curiam,* 324 U. S. 826.

The Tax Court's confusion with respect to these separate subsections is evident from its statement that (R. 82)—

> the statutory provision providing that pre-March 1, 1913, earnings or profits may be distributed, tax free, in no way affects the general rule stated and gives no basis for any conclusion that Congress, in recognizing, as the Supreme Court stated in *Lynch* v. *Hornby, supra,* the equity of stockholders as to pre-March 1, 1913, earnings, intended to legislate with respect to restoration or non-restoration of capital which has been impaired by operating losses. * * *

The point of the matter is that, as we have seen, Section 115 (b) deals with the tax-free distribution of pre-1913 earnings; it is complete by itself to accomplish this Congressional policy. We agree that Section 115 (b), dealing as it does with corporations having a surplus on March 1, 1913, does not itself evidence any legislative intent respecting corporations whose capital was impaired on that date. Section 115 (b), however, does not stand alone; the provisions of Section 115 (a)(1), and the reference there to earnings and profits accumulated after March 1, 1913, cannot be ignored or considered as echoing the provisions of Section 115 (b), as the Tax Court did. While Section 115 (b) evidences one Congressional policy with respect to pre-1913 earnings, Section 115 (a)(1) embodies a different legislative purpose, namely, to tax the distribution of all profits earned subsequent to March 1, 1913. The conclusion is inescapable that the legislature in Section 115 (a)(1) made it manifest that an absence or deficiency in earnings and profits on February 28, 1913, is without any significance in determining what earnings and profits are accumulated thereafter.

If Congress had intended the meaning which the Tax Court has read into the statute, the section, as we have

already observed, would have been drafted differently. Section 115 (b) would have remained the same, thus insuring that earnings or profits accumulated before March 1, 1913, could be distributed tax-free after the distribution of profits accumulated subsequent to that time. But Section 115 (a)(1) would have been different if, in the case of corporations having a deficit on March 1, 1913, Congress had intended to tax only such distributions which were subsequently made out of accumulated earnings or profits, measured over the whole of the corporation's life. To accomplish this, Section 115 (a) would only have had to refer to the accumulated earnings or profits of a corporation—not to those accumulated after March 1, 1913.

C. *The Tax Court's construction of the statute creates an exemption where none was intended by Congress and is opposed by the Congressional policy of taxing as dividends all distributions of post-1913 corporate profits.*

The construction adopted by the Tax Court not only renders meaningless the reference to earnings and profits "accumulated after February 28, 1913," but it results in stretching an exemption (which was created by Congress in Section 115 (b) to cover only a limited area) to make it cover an altogether different and broader situation under Section 115 (a)(1). That is, in making this "concession to the equity of stockholders" (*Lynch* v. *Hornby,* p. 346), so that pre-March 1, 1913, accumulations of earnings would not be taxed when distributed, Congress created a specific and limited exception in Section 115 (b) which has been narrowly construed (*Helvering* v. *Canfield,* 291 U. S. 163). By providing, however, that corporate distributions should be deemed to be made from the most recently accumulated earnings and profits, and that the distribu-

tion of pre-March 1, 1913, earnings should be tax-free only after all earnings and profits accumulated subsequent to February 28, 1913, have been distributed, Section 115 (b) makes it manifest that the exemption with respect to the pre-March 1, 1913, earnings must be limited so as not to interfere with the broad, parallel Congressional purpose not to permit "profits accumulated after that date to escape taxation." *Helvering v. Canfield, supra,* p. 168.

From this limited exemption under Section 115 (b), relating to corporations with a surplus on March 1, 1913, the Tax Court by a complete *non-sequitur,* creates a different exception under Section 115 (a)(1) for corporations possessing a deficit on that date. And, despite a Congressional purpose to tax, when distributed, all earnings subsequently accumulated, the Tax Court reaches the strange result that the stockholders of a corporation which had a deficit on March 1, 1913, stand in a preferred position.

It was one thing for Congress, as it did in Section 115 (b), to act out of regard for the stockholder's equity in pre-March 1, 1913, earnings when the corporation possessed a surplus on that date, and to exempt such earnings from taxation when distributed. But it would have been an altogether different matter for Congress to have provided that, where the corporation possessed a deficit on that date, a stockholder should first have his 1913 equity restored to what it would have been if the corporation had not actually possessed a deficit. The Tax Court, in reading such a requirement into the statute, has extended a guarantee to the stockholders that a March 1, 1913, deficit will be restored out of subsequent earnings before any distributions will be taxed —a guarantee that has no support either in the purpose or language of the statute.

Congress, on the contrary, did not even guarantee under Section 115 (b) that a March 1, 1913, surplus would remain intact for tax-free distribution to the shareholders. Thus, in *Helvering* v. *Canfield, supra,* the corporation had a surplus of some $4,000,000 on March 1, 1913, a small profit in 1914, a loss of over $190,000 in 1915, a loss of over $200,000 in 1916, and profits of more than $2,400,000 from 1917 to 1923. The taxpayer contended that its earnings and profits which were accumulated after March 1, 1913, had to take into account the 1915 and 1916 losses, so that those would not reduce the amount of its March 1, 1913, earnings and profits which could be distributed free of tax. The Supreme Court held, however, that the 1913 surplus was in fact diminished by the 1915 and 1916 losses, and that the later profits, in their entirety, were accumulated after March 1, 1913, and available for distribution as taxable dividends. In so holding, the Court said that the statutory provisions there, similar to those embodied in Code Section 115 (a) and (b) (p. 168)—

> disclose a single purpose and are to be construed in harmony with each other. They show that the Congress was careful to arrange its plan so that the right to receive, free of tax, a distribution of surplus accumulated prior to March 1, 1913, should not be exercised in such a fashion as to permit profits accumulated after that date to escape taxation. * * *

The Court also said, in referring to the Congressional recognition of the stockholder's equity in earnings accumulated prior to March 1, 1913, and the statutory privilege of receiving distributions of such earnings free of tax, that (p. 168)—

> that equity is not apparent when those profits had been lost in whole or in part and immunity is sought

from the taxation of an equivalent amount of profits subsequently earned.

Since Congress, despite its express statutory concern with the stockholder's equity where the corporation possessed a surplus on March 1, 1913, did not warrant that this surplus would remain intact for tax-free distribution, or intend that future earnings should be devoted to restoring an intervening diminution of this surplus before being considered as a post-1913 accumulation available for dividend purposes, it is inconceivable that, despite its lack of any statutory concern with a corporation possessing a deficit on March 1, 1913, Congress should have simultaneously intended that the subsequent earnings of such a corporation should first be devoted to its deficit before being considered as a post-1913 accumulation available for taxable dividends.

The Tax Court has plainly misconceived the March 1, 1913, reference point in the statute. As the Court observed in *Helvering* v. *Credit Alliance Corp.,* 316 U. S. 107, 111, that date is "The line drawn in all of the revenue acts between profits accumulated before the enactment of the first income tax act and after that date, for distinguishing capital and income * * *."

To the limited extent that it created an exemption with respect to corporate distributions of pre-1913 accumulations, Congress treated the stockholder's share in such surplus as though it were a return of capital. *Helvering* v. *Canfield, supra,* pp. 169-170; *Foster* v. *United States,* 303 U. S. 118, 121. See also H. Rep. No. 179, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 241, 249), where in reporting on the Revenue Act of 1924, the Committee on Ways and Means observed: "The theory which causes the allowance of the receipt of the dividend free of tax is that this distribution, being out of earnings accumulated prior to March 1, 1913, constitutes a return of capital to the stockholders."

Such a statutory concept of March 1, 1913, capital where a surplus existed on that date can scarcely be extended to include a stockholder's interest in a surplus which did not exist on that date, i.e., the corporate deficit, or lead to the conclusion that post-1913 earnings are to become pre-1913 capital. Yet, the Tax Court here has held, in effect, that profits earned by the corporation after March 1, 1913, nevertheless represent part of the statutory capital of the stockholder which existed on March 1, 1913.

Actually, the limited Congressional concern with pre-1913 earnings negates the conclusion that Congress should have intended any larger exemption with respect to post-1913 accumulations by corporations having a deficit on the critical date. Indeed, the *Canfield* case illustrates how Congress was intent on taxing all post-1913 accumulations when distributed. The same idea was repeated in *Foster* v. *United States, supra,* pp. 120-121, where the Court said:

> We are urged so to expand and broaden an exemption granted by Congress as a "concession to the equity of stockholders" that such concession would in reality serve to nullify and defeat the tax on corporate profits earned after 1913. Courts should construe laws in harmony with the legislative intent and seek to carry out legislative purpose. With respect to the tax provisions under consideration, there is no uncertainty as to the legislative purpose to tax post-1913 corporate earnings. We must not give effect to any contrivance which would defeat a tax Congress plainly intended to impose. * * *

It is quite apparent that the Tax Court, in construing the statute so that post-1913 earnings will not be considered as accumulations available for taxable dividends until after they have been devoted to a March 1,

1913, deficit, has permitted such earnings to escape taxation, contrary to the general intention of Congress.

While Congress, though not required to do so under the Constitution, has acted to exempt from tax any distribution of corporate earnings accumulated before March 1, 1913, there is no sound reason why it should not have taxed all distributions from subsequently accumulated earnings. And, quite clearly, there was no constitutional requirement that such subsequent earnings should first be applied to a March 1, 1913, deficit, if one existed. Indeed, under Code Section 115 (a), clause (2), which had its origin in the same section of the Revenue Act of 1936, c. 690, 49 Stat. 1648, any corporate distribution is taxable as a dividend to the extent that there are "earnings or profits of the taxable year," regardless of the fact that the corporation, at the time of the distribution, actually possesses a current deficit in accumulated earnings and profits. The validity of this has never been questioned. By like token, Congress possessed full authority to tax the distribution of post-1913 accumulations of earnings or profits, regardless of the existence of a pre-1913 deficit.

Even if these positive matters did not so conclusively demonstrate the error of the decision below, a rejection of the Tax Court's construction of the statute would nevertheless be required. Section 22 (a) of the Code includes "dividends" as one of the sources of a taxpayer's income. The sweeping definition of gross income in Section 22 (a) had frequently been held to represent an exercise by Congress of its full constitutional authority to impose a tax on income from whatever source derived. *Irwin* v. *Gavit,* 268 U.S. 161, 166; *Douglas* v. *Willcut,* 296 U.S. 1, 9; *Helvering* v. *Clifford,* 309 U.S. 331, 334; *Commissioner* v. *Smith,* 324 U.S. 177, 181, rehearing denied, 324 U.S. 695. While, by exemptions, and other exceptions, Congress has elsewhere

refrained from taxing certain items of income which might be taxed under the Constitution, the result of the broad definition of gross income in Section 22 (a) is that no income which might be taxed under the Constitution can escape taxation except where Congress has specifically created an exception.

Since the kind of distributions here in issue could be constitutionally taxed, the question to be answered is whether an exemption exists of the kind which the Tax Court has read into the statute. In this connection, it must be borne in mind, as the dissenting opinion below correctly observed (R. 105-106), that exemptions are to be strictly interpreted, they cannot rest on implication, and a taxpayer, to be entitled to an exemption, must show that he has plainly been touched by the legislative grace. *Commissioner* v. *Jacobson,* 336 U.S. 28, 49; *Helvering* v. *Northwest Steel Mills,* 311 U.S. 46, 49; *United States* v. *Stewart,* 311 U.S. 60, 71. From what we have already demonstrated with respect to the statute, we believe that it is plain that these conditions do not exist. An analysis of the Tax Court's opinion, and the matters on which it rests, moreover, fails to disclose any basis on which an exemption can be implied from the statute, even if an exemption could legitimately rest on mere implication.

D. *The matters relied on by the Tax Court do not support its construction of the statute.*

The Tax Court, in its opinion (R. 71-83), relies heavily on the fundamental proposition that, as a matter of general corporation law, a corporation whose capital has been impaired cannot possess a surplus for distributing dividends so long as its capital remains impaired. It stated that the Commissioner's contention (R. 71) "is plainly contrary to fundamental principles of corporation law."

This, however, carries not the slightest weight of persuasion since the Congressional definition of a dividend and its concept of earnings and profits, for tax purposes, depart in many respects from principles of general corporation law and from corporate accounting practices. Thus, in *Commissioner* v. *Wheeler,* 324 U.S. 542, 546, the amount of the corporation's earnings and profits was different than that which would have resulted if general principles of corporation law had been followed, the Court saying:

> But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting principles either.

Again, in *Commissioner* v. *Phipps,* 336 U.S. 410, 420-421, it was held that the deficit of one corporation was not "inherited" by another corporation, even though it acquired the assets of the former in a tax-free exchange;[4] the Court rejected the argument that the tax consequences ought to follow corporate accounting practices, saying:

> The answer is brief. The *Sansome* rule itself, as applied to earnings and profits, has never been thought to be controlled by ordinary corporate accounting concepts; its uniform effect is to treat for tax purposes as earnings or profits assets which are properly considered capital for many if not most corporate purposes, and it has long been a commonplace of tax law that similar divergences often occur. * * *

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[4] The *Phipps* case was followed by the Tax Court as it related to one of the issues below, namely, whether the earnings and profits of the Spreckels Company was to be reduced by the deficits of the Monterey County Water Company, and Seventh and Hill Building Corporation, wholly owned corporations, which were liquidated in tax-free transactions. (R. 97-98.)

In the *Wheeler* and *Phipps* cases, *supra,* and also in *Commissioner* v. *Munter,* 331 U.S. 210, where the Supreme Court gave its sanction to the rule of *Commissioner* v. *Sansome,* 60 F. 2d 931 (C.A. 2d), namely, that a corporation does "inherit" the accumulated earnings and profits of another when it acquires its assets in a tax-free exchange, there was a divergence between accumulated earnings and profits under Section 115, for tax purposes, from what would be true under corporation accounting principles. This divergence and, indeed, the difference between the *Phipps* and *Munter* cases (holding that, in a tax-free acquisition of a corporation's assets, its earnings and profits are inherited by the transferee but that a deficit is not) reflect the Congressional purpose of taxing to the shareholders any distribution of accumulated corporate earnings, and of insuring that none should be distributed free from the normal income tax, except as Congress has expressly provided to the contrary.

The Tax Court, accordingly, was wrong in believing that here there must be an equation between the amount of the corporation's surplus, under general corporate accounting principles, and the amount of its earnings and profits, under taxation principles. On the contrary, as was true in the above cited cases, a divergence between the two is also required here in order to give meaning to the reference to February 28, 1913, in Section 115 (a)(1), and to give effect to the Congressional purpose not to permit "profits accumulated after that date to escape taxation." *Helvering* v. *Canfield, supra,* p. 168.

The Tax Court attempted to bolster its reliance on corporate accounting principles by emphasizing the idea (R. 76-85) that there can be no "accumulation" of earnings or profits while a pre-1913 deficit is still extant. A somewhat similar accentuation of the word "ac-

cumulated" was made by the taxpayer in *Helvering* v. *Canfield, supra,* where the Court, in rejecting the taxpayer's argument, said (p. 169): "The argument for the stockholders stresses the word 'accumulated.' We think that the expression is made to carry too heavy a burden." That retort is even more apt here where, in concentrating on the word "accumulated," the Tax Court completely ignored the period during which Congress made the accumulations relevant for tax purposes. As we have already observed, Congress legislated from the standard of what earnings or profits were accumulated after February 28, 1913, while the Tax Court insisted on making the calculation extend back to the very beginning of the corporation's life.

The Tax Court, in this connection, also relied (R. 76-83) on the authorities which hold that, where a corporation incurs a deficit subsequent to March 1, 1913, there can be no accumulation of earnings and profits after that time until the deficit has been removed. We do not question those decisions. Indeed, they illustrate that the statute means what it says when it speaks of "earnings or profits accumulated after February 28, 1913," for any deficit (computed in the tax sense rather than by corporate principles) occurring after March 1, 1913, necessarily determines how much of the subsequent profits can become translated into earnings or profits accumulated after that time.

The Tax Court's mistake, however, was in thinking that these cases, involving corporations with a surplus on March 1, 1913, were (R. 82) "equally applicable to impairment of capital *whenever* suffered or sustained * * *." (Italics supplied.) On the contrary, Section 115 (a)(1), in focusing on earnings and profits accumulated after March 1, 1913, makes pregnant the very distinction between the situations which the Tax Court considers to be insignificant. The amount of earnings

and profits which are accumulated by a corporation after March 1, 1913, is definitely affected by any operating deficit occurring after the critical date. But for the many reasons already mentioned, the amount of profits accumulated after March 1, 1913, cannot be affected by a deficit existing before that date.

It is noteworthy that, among the cases cited by the Tax Court for the proposition that there can be no accumulation of earnings or profits while an impairment of capital exists (R. 76) is *Hadden* v. *Commissioner,* 49 F. 2d 709 (C.A. 2d), where, in fact, the Court of Appeals, to the extent that there was a March 1, 1913, deficit, assumed the exact opposite. There the corporation had a deficit on March 1, 1913, in excess of $500,000. From that date until 1917, it had additional losses of approximately $330,000. During 1917 it had net profits of about $450,000 and the tax on its 1917 profits was about $54,000. In determining what portion of a 1917 distribution was taxable as a dividend, the court held that the earnings and profits accumulated since March 1, 1913, and available for distribution as a dividend must take into account the operating losses incurred since March 1, 1913. Significantly, although the Tax Court overlooked this completely, the circuit court did not deduct the $500,000 deficit which existed on March 1, 1913, in determining the amount of earnings or profits accumulated since that time.

The court in the *Hadden* case (p. 711) used the following broad language, which was relied on (R. 81) by the Tax Court to support its conclusion:

> No earned surplus can be accumulated until the deficit or impairment of paid-in capital has been made good. Dividends paid while there is an operating deficit should be deemed to be from capital or paid-in surplus even though there are earnings of the taxable year sufficient to pay the dividend in whole or in part. * * *

The Tax Court failed to appreciate, however, that this broad language was limited to deficits arising after March 1, 1913. This is evident not only from the fact that the court in the *Hadden* case did not take the 1913 deficit into account in its calculations, but also from the ensuing statement in its opinion to the effect that (p. 711)—

> the accumulated profits since March 1, 1913, must necessarily mean the net excess of all profits between March 1, 1913, and the date of distribution, *less all losses sustained between the same dates* * * *. (Italics supplied.)

It is true that in the *Hadden* case the court assumed, without discussing the point, that the existence of the March 1, 1913, deficit had no effect on the amount of earnings and profits subsequently accumulated. The result there, however, is consistent with the Commissioner's position and can scarcely be deemed an authority which supports the Tax Court's conclusion. Moreover, it is a significant illustration why the authorities relied on by the Tax Court are not at all opposed to the Commissioner's contentions and why the Tax Court's reasoning embodies a patent *non-sequitur*.

So far as we have been able to ascertain, the problem of the present case was involved in the facts of only two other cases.[5] In each, however, the issue was

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[5] In the taxpayers' brief in the Tax Court the following statement was made (pp. 24-25):

> To construe the statute to mean that such a distribution is taxable to the recipient as income would raise serious constitutional problems, *which no doubt explains why such a construction of the statute has never heretofore been advanced by the Treasury Department, so far as we have been able to ascertain.* (Italics supplied.)

The underscored language might lead to the inference that the present cases represent the first time in the long history of the taxing statute that the Commissioner has invoked the construction of the statute on which we rely. Such an inference would be altogether

merely lurking, and the question was not raised directly; in neither did it become a matter to which the decision gave a direct answer. In *Hoffman* v. *United States,* 53 F. 2d 282 (C. Cls.), the corporation had a deficit on March 1, 1913, and the court, as in the *Hadden* case, *supra,* also assumed that subsequent earnings were available for distribution as taxable dividends without regard to the prior deficit. Thus, the court said (p. 290):

> If the profit of 1913 had been distributed in that year, we think it would have been taxable, notwithstanding there was an operating deficit prior to March 1 of that year. * * *

In the *Hoffman* case the court was primarily concerned with the manner of computing what distributions had been made out of increases in value of property accrued prior to March 1, 1913, and the problem concerning the effect of the pre-1913 deficit was not dealt with as a specific issue.

In *Chapman* v. *Anderson,* 11 F. Supp. 913 (S.D. N.Y.), the court, also without discussing the point, indulged in the opposite assumption, namely, that a pre-1913 deficit is required to be absorbed by subsequent earnings before there can be accumulated earnings and profits available for dividend purposes. The *Chapman* case focused entirely on the question whether the write-up on the corporate books in 1925 of the value of the corporate assets as of March 1, 1913, was suffi-

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wrong. In response to a request for information by the Department of Justice on this matter, the Chief Counsel, Bureau of Internal Revenue, by letter dated December 12, 1950, stated that "it has been the long-standing practice of the Bureau to not require that a pre-1913 deficit be eliminated before there can be earnings and profits available for dividends."

While the present cases apparently involve the first time that taxpayers have controverted the Commissioner on this precise point, the absence of prior litigation does not mean that the Commissioner has lately shifted position. The contrary is true.

cient to eliminate the March 1, 1913, deficit. That the court entirely missed the significance of what it was deciding, *sub silentio,* is evident from the fact that it relied on *Hadden* v. *Commissioner, supra,* which, as we have seen, applied the statute in a contrary manner. While the Tax Court thought that the *Chapman* case was (R. 80) "directly in point," the decision there, for the reason just stated, cannot be considered as persuasive authority in support of the Tax Court's decision.

In view of the foregoing, we submit that there is no rational basis for the tax exemption which the Tax Court has read into the statute. Since, on the contrary, there are compelling reasons to support the Commissioner's contention that the statute means what it says in defining a dividend in relation to earnings or profits accumulated after February 28, 1913, so that such accumulations would not be affected by the existence of a corporate deficit on that date, the construction of the statute adopted by the Tax Court should be rejected.

CONCLUSION

The decisions of the Tax Court should be reversed.

Respectfully submitted,

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FEBRUARY, 1951.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1940 ed., Sec. 22.)

(Sec. 22 (a) of the Revenue Acts of 1938, c. 289, 52 Stat. 447; 1936, c. 690, 49 Stat. 1648; Sec. 213 (a) of the Revenue Acts of 1926, c. 27, 44 Stat. 9; and 1918, c. 18, 40 Stat. 1057, and Sec. 2 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756, as amended by Sec. 1200 of the Revenue Act of 1917, c. 63, 40 Stat. 300, contain provisions which, as they relate to the issue of this case, are substantially similar to the above quoted portion of Sec. 22 (a) of the Internal Revenue Code.)

Revenue Act of 1916, c. 463, 39 Stat. 756:

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from in-

terest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided,* That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

* * * * *

INTERNAL REVENUE CODE:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free

distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

(Sec. 115 (a) and (b), Revenue Acts of 1938 and 1936 are identical. Sec. 201 (b), Revenue Acts of 1926, 1918, and Sec. 31 (b), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, are, as they relate to the issue of this case, substantially similar to Section 115 (b), Internal Revenue Code.)

Revenue Act of 1926, c. 27, 44 Stat. 9:

Sec. 201. (a) The term "dividend" when used in this title (except in paragraph (9) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

* * * * *

(Secs. 201 (a), Revenue Act of 1918, and 31 (a), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, as they relate to the issue of this case, are substantially similar to Section 201 (a), Revenue Act of 1926, quoted above.)

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